

**Comment on European Banking Authority Consultation Paper on
“Draft Guidelines on the Management of Interest Rate Risk and Credit
Spread Risk Arising from Non-Trading Book Activities” (EBA/CP/2021/37)**

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Two comments, one specific on Question 1 (cap of five years on the repricing maturity of non-maturity deposits) and a second one more generic on the correct measurement of interest rate risk on the non-trading book.

Question 1

A single number – a cap of five years for the duration of non-maturity deposits (NMD’s) – creates a false sense of security. As an example, if the effective duration of zero-interest demand deposits is eight years, then investing in a five year-fixed income asset would create interest rate risk. In the case of a lower interest rate environment with assets maturing at end of five years, re-investing at a lower interest rate will reduce net interest income. This is the situation faced by many European banks in 2021.

Let us recognize the very large uncertainty on the effective duration of NMDs. With competition from Fintechs, it is not yet clear how digital natives younger generation will remain loyal to their bank with sticky deposits and what will be the deposit rate elasticity. In such a situation of uncertainty, the proper way to evaluate and mitigate risk is not to impose an artificial cap of five years on NMDs. Let banks choose the effective deposit duration for different segments of clients. But then in running the stress test exercise, it is not only to run scenarios with large change of interest rates but also to look at shocks to the duration of NMDs. In the supervisory ICAAP exercise, one would check that the bank has enough equity to face each potential scenario.

Generic comment on correct measurement of interest rate risk

To measure interest rate risk on the non-trading book, EBA recommends to monitor both the impact of a change of interest rates on the net interest income (NII) and on the economic value of equity (EVE). In so doing it follows the recommendation of the Basle Committee (2016).

It is well known that banks cannot hedge simultaneously the net interest income and the economic

value of equity. A simple example will illustrate. Take a portfolio of short-term treasury bills funded exclusively with equity. The balance sheet is as follows:

Treasury Bills	Equity
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Treasury bills having a very short duration, the economic value of equity is hedged as a change of interest rate will not change the value of the treasury bill portfolio. However the net interest income is exposed as a reduction of interest rate will reduce interest income on short-term treasury bills. If equity had been invested in long-term fixed rate bonds, the net interest income would have been hedged.

Banks appear to have to choose which variable to hedge: economic value of equity or net interest income. As financial analysts focus on return on equity and earnings per share, it is likely that the bias will be to hedge net interest income and profit. This would not be welcome by bank supervisors in charge of bank solvency. They must insure that the value of assets cover the value of the debt, that is they must focus on the economic value of equity.

Fortunately this apparent dilemma – hedging NII or economic value of equity – can be resolved¹ if one does not focus anymore on the change of net interest income, but on the change of economic profit (EP), that is the difference between profit and the cost of equity

Economic Profit (EP) = Profit - Equity x Cost of Equity.

As the cost of equity is measured as an opportunity investment rate evaluated as the risk-free bond rate plus a risk premium, it follows that the cost of equity increases when interest rate increases. In the simple example above, the investment in treasury bills will not only hedge the economic value of equity, it would also hedge the economic profit. Lower interest rates would reduce interest income on short-term treasury bills but they would also lower the cost of equity.

So as to nudge banks in the right direction in measuring and managing the interest rate risk on the non-trading book, EBA should mention explicitly that there is an alternative to the net

¹Dermine (2015, p. 277).

interest income measure of risk, that is the economic profit evaluated as profit net of a cost of equity².

References

Basel Committee on Banking Supervision (2016): Interest Rate Risk on the Banking Book, Basel.

Dermine J. (2015): Bank Valuation and Value-based Management, Mc GrawHill, 2nd edition, NY.

European Banking Authority (2021): Consultation Paper on Draft Guidelines on the Management of Interest Rate Risk and Credit Spread Risk Arising from Non-Trading Book Activities, EBA/CP/2021/37.

²One can observe an inconsistency in banking where performance of business units are correctly measured with economic profit (allocated profit net of a cost of allocated equity) but where the measurement of interest rate risk focuses on the impact of interest rate on net interest income (profit), ignoring the impact on the interest rate sensitive cost of equity.

